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IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-818

TENNESSEE-CAROLINA TRANSPORTATION, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioners pray that a Writ of Certiorari be issued to review the Order of the United States Court of Appeals for the Sixth Circuit entered on August 21, 1978.[1]

CITATIONS TO ORDERS AND OPINIONS BELOW

The decision of the entire United States Tax Court with seven judges dissenting, was adverse to the taxpayer. The Tax Court's opinions have been officially

[1] The petitioner is only seeking a Writ of Certiorari to review the Court of Appeal's decision that the "tax benefit rule" overrides the nonrecognition provisions of § 336 of the Internal Revenue Code of 1954. The petitioner no longer contests the valuation issue.

reported at 65 T.C. 440 (1975).[2] A three judge panel of the Court of Appeals for the Sixth Circuit with one judge dissenting[3] affirmed the Tax Court's opinion. The Court of Appeals' decision has been unofficially reported at 42 A.F.T.R. 2d 78-5716 and 78-2 U.S.T.C. ¶ 9671.[4]

JURISDICTION

The Order of the Court of Appeals was entered on August 21, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

THE QUESTION PRESENTED

If this Honorable Court grants the petitioner's request to review the Decision of the Court of Appeals for the Sixth Circuit, the following question will be presented to this Court on the Writ of Certiorari:

> Did the majority of both the United States Tax Court and the three judge panel of the Court of Appeals correctly decide that the "tax benefit rule" overrides the statutory nonrecognition provisions of § 336 of the Internal Revenue Code of 1954?

STATUTES INVOLVED

The statute involved is a section of the Internal Revenue Code of 1954, as amended, which is codified as Title 26 of the United States Code. The section relied upon by the petitioners is as follows:

[2] The Tax Court's decision including the concurring and dissenting opinions is printed as Appendix A hereto.

[3] Judge Weick dissented as to the majority's decision that "tax benefit rule" overrides the nonrecognition provisions of § 336 of the Internal Revenue Code of 1954. He concurred in the affirmation of the valuation issue.

[4] The opinion of the Court of Appeals is printed as Appendix B hereto.

SEC. 336. GENERAL RULE.

> Except as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss should be recognized to a corporation on the distribution of property in partial or complete liquidation.

STATEMENT

The petitioner is a Tennessee Corporation engaged in the motor freight transportation business. During 1966, the petitioner contracted to purchase all of the capital stock of Service Lines, Inc. (Service)[5] for $1,980,190.05. Service was also engaged in the motor freight transportation business. The sale was closed on January 3, 1967, and Service was operated as a wholly-owned subsidiary of the petitioner until March 1, 1967. At that time, the petitioner liquidated Service. The liquidation consisted of Service distributing all of its assets to the petitioner in exchange for Service's stock which was then retired. Among the assets received by the petitioner from Service were tires and tubes which were mounted on Service's equipment at the date of liquidation. Since the tubes and tires had a useful life of approximately one year or less when Service acquired them, it fully deducted their cost upon purchase. In accordance with section 334(b)(2) of the Internal Revenue Code of 1954 (26 U.S.C. § 334(b)(2)), petitioner claimed a stepped-up basis in the assets received from Service by allocating the purchase price of the Service stock proportionately to the assets received based on their

[5] The petitioner actually purchased the stock of four related corporations: Service Line, Inc., Linn Leasing, Inc., Third Street Realty, Inc. and Lynch Redevelopment Corporation. However, it is only the tax liability of Service that gives rise to the dispute in this case.

respective fair market value.[6] The petitioner thereafter fully deducted the amounts so allocated to the tires and tubes as a business expense on the consolidated return it filed with Service for 1967. This was proper since the tires and tubes had a useful life of less than one year in the petitioner's business as they had in Service's business.

The respondent claimed that the 1967 consolidated return underreported income. The respondent's theory was that the tax benefit rule required Service to include in income for 1967 the fair market value of the tires and tubes it distributed to the petitioner. Since a consolidated return was filed, the petitioner's deduction for the tires and tubes would be offset by the income reported by Service pursuant to the respondent's theory.

As mentioned, the Commissioner's position was upheld by the full Tax Court with seven judges dissenting. 65 T.C. 440 (1975). Both the Tax Court and the Sixth Circuit held *contra* to the decision by the Court of Appeals for the Ninth Circuit in *Commissioner* v. *South Lake Farms, Inc.*, 326 F.2d 837 (1963), that the "tax benefit rule" overrode the statutory nonrecognition provisions of § 336 of the Internal Revenue Code of 1954.

REASON FOR GRANTING THE WRIT

The decisions below should be reviewed pursuant to Supreme Court Rule 19(1)(b) because the Court of Appeals has decided a federal question in direct conflict with the decision of another Court of Appeals on the same matter. The decisions should also be reviewed be-

[6] While petitioner contended that tires and tubes had a fair market value of $94,940.00, the Tax Court found the value of the tires and tubes to be $36,395.00. As previously mentioned, the Circuit Court affirmed as to this issue. (Appendix A, p. A-9; Appendix B, p. B-2, fn. 2.)

cause they are in conflict with the applicable decision of this Court in *Nash* v. *United States*, 398 U.S. 1 (1970).

BY RULING THAT THE TAX BENEFIT RULE OVERRIDES THE STATUTORY NONRECOGNITION PROVISIONS OF SECTION 336, THE COURT OF APPEALS ENTERED A DECISION IN CONFLICT WITH THE COURT OF APPEALS FOR THE NINTH CIRCUIT IN *SOUTH LAKE FARMS*; DECIDED THE CASE IN CONFLICT WITH THE RATIONALE OF THIS COURT IN *NASH*; AND BY A NOVEL APPLICATION OF THE TAX BENEFIT RULE, APPLIED IT TO A PREVIOUSLY INAPPLICABLE SITUATION.

In deciding the instant case, the Court of Appeals expressly rejected the notion that an actual physical recovery of some tangible asset or sum is necessary in order to apply the tax benefit rule. (Appendix B, p. B-7). As noted in Footnote 13 of the majority opinion (Appendix B, *supra*), this Decision is in direct conflict with the holding of the Court of Appeals for the Ninth Circuit in *Commissioner* v. *South Lake Farms, supra.* Moreover, Judge Weick in his dissent, also points out that the majority decision rejects the Ninth Circuit's result in *South Lake Farms* and causes a conflict in the Circuits' decisions. (Appendix B, p. B-17). The Petitioner contends that this conflict between the Circuits on an important federal tax question has created an inequitable burden on taxpayers in different locals of the country and the Court should grant this petition for a Writ of Certiorari to review the judgment of the Court of Appeals for the Sixth Circuit.

Not only is the Court of Appeals' decision in the instant case in conflict with the Ninth Circuit's decision, it results in a misapplication of the tax benefit rule contrary to the decision of this Court in *Nash* v. *United States*, 398 U.S. 1 (1970). In the *Nash* case, the Commissioner argued that

under the tax benefit rule, unused amounts of a bad debt reserve must be restored to income when the reserve is found to be no longer necessary. In that instance, the partnership had transferred all of its assets to a corporation pursuant to section 351(a) of the Internal Revenue Code of 1954 (26 U.S.C. § 351(a)). The Commissioner argued that the partnership's need for the reserves had ended with the termination of its business and the amounts previously deducted should be restored to income. This Court ruled that the end of a need is not synonymous with the word recovery in the meaning of the tax benefit rule. Thus, this Court made a determination in *Nash* that the failure of a taxpayer to receive an actual economic recovery of its bad debt deduction prohibited application of the tax benefit rule.

In the present case, the Sixth Circuit has stated that what justifies the application of the tax benefit rule is the inconsistency of the two events, purchase and distribution. (Appendix B, pp. B-6-B-7). In other words, it is inconsistent for Service to have deducted the tires upon purchase and yet to have transferred them with value to Tennessee-Carolina, the petitioner. The petitioner agrees with the various dissenting opinions that there is no difference between the end of the need argument which the Commissioner advanced in *Nash* and the rationale of inconsistent events used in this case. As previously noted, Service received no actual economic recovery when it distributed the tires and tubes to Tennessee-Carolina. Any economic recovery, if any, went to the old shareholders who sold their stock to the petitioner. The inconsistent events test has the same basis and result as the end of need test which this Court refused to apply in *Nash*.

The Court also attempts to reconcile this absence of an actual economic recovery with the *Nash* decision by fictionalizing an economic recovery. (Appendix B, pp. B-7 and B-8). Both the Tax Court majority and the Sixth Circuit majority held that immediately prior to Service's liquidation, it recovered tubes and tires equal in value to the tubes and tires that it distributed upon liquidation to its parent. This is the same argument which the government advanced in *South Lake Farms*, when it argued that immediately prior to the liquidation the old corporation received an amount equivalent to, and sufficient to offset, the expenses that it had incurred. Therefore, the subsidiary was no longer entitled to the tax benefit of the expense deduction.

As the dissents point out in the instant case, in agreement with the decision of the Court of Appeals in the Ninth Circuit in *South Lake Farms*, the problem with this contention is that the old corporation received nothing. Shareholders of the old corporation are the ones who sold their stock and received the money. As the Ninth Circuit held, the old corporation received nothing and nowhere in the Code is there an intent that the gains of the old shareholders, who obviously gained due to the increased value of the tax benefit, were to be attributed to the corporation, much less treated as ordinary income to the corporation. Moreover, any gains to the old shareholders should have resulted in additional taxes to them. *Commissioner* v. *South Lake Farms, supra*, p. 839.

It is clear that the Tax Court and the Court of Appeals for the Sixth Circuit have applied the tax benefit rule in a novel situation contrary to decision of the Court of Appeals for the Ninth Circuit in *South Lake Farms* and this Court's decision in *Nash*.

Moreover, this application of the tax benefit rule is in conflict with the numerous decisions of other Courts where application of the tax benefit rule has been only in those situations where the taxpayer's previous deduction was returned to it by either an actual recovery of an asset or a change to an accrued liability resulting in an increase to the taxpayer's net worth. See: *Anders* v.

United States, 462 F.2d 1147 (Ct. Cl., 1972), cert. denied 409 U.S. 1064 (1972); *Bear Mfg. Company* v. *United States*, 430 F.2d 152 (C.A.7, 1972), cert. denied 400 U.S. 1021 (1972); *Citizens' Acceptance Corporation* v. *United States*, 462 F.2d 751 (C.A.3, 1972); *Mayfair Materials, Inc.* v. *Commissioner*, 456 F.2d 622 (C.A.5, 1972); *Spitalny* v. *United States*, 430 F.2d 195 (C.A.9, 1970); *North American Coal Corporation* v. *Commissioner*, 97 F.2d 325 (C.A.6, 1938).

Thus it is apparent that this case presents an important question under federal tax laws as to whether the statutory nonrecognition provisions of § 336 of the Internal Revenue Code of 1954, are overriden and subject to the tax benefit rule where the recipient of the previous tax benefit does not make an actual economic recovery. Moreover, as recognized by the Court of Appeals for the Sixth Circuit, its decision in this case is in conflict with the decision by the Court of Appeals for the Ninth Circuit in a prior case.

Finally, the Court of Appeals' decision is in conflict with this Court's decision in *Nash*. Clearly, review by this Court is necessary to provide for uniform application of the Internal Revenue laws as to this important question of federal law

CONCLUSION

For the reasons previously set forth, the petitioner respectfully requests that a Writ of Certiorari be granted to review the Order of the United States Court of Appeals for the Sixth Circuit which affirmed the Order of the United States Tax Court.

Respectfully submitted,

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Appendices

APPENDIX A

UNITED STATES TAX COURT

65 T. C. No. 39

TENNESSEE CAROLINA TRANSPORTATION, INC.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 3963-73

Filed December 1, 1975.

1. The fair market values of a terminal facility and of tires and tubes distributed to petitioner on the liquidation of a wholly owned subsidiary are determined.

2. S, a corporation, was engaged in the motor freight transportation business. It purchased tires and tubes for its own equipment and for equipment which it leased for use in its operations. The cost of procuring tires and tubes to be mounted on equipment already in use was expensed when the tires and tubes were placed in service. The cost of tires and tubes purchased with new equipment was expensed at the time of the purchase. S was permitted to expense the cost of its tires and tubes on the assumption that their average useful life was one year or less.

S was liquidated before the useful life of certain of its tires and tubes had been exhausted. These tires and tubes were distributed in liquidation to S's sole shareholder. *Held*, on its liquidation S had to include in gross income the lesser of the fair market value of the tires and tubes

distributed or the portion of their cost attributable to their remaining useful life.

H. Stennis Little, Jr., for the petitioner.

Richard J. Neubauer, for the respondent.

FAY, *Judge*: Respondent determined the following deficiencies in the Federal income tax of petitioner:

1964	$ 5,520.23
1965	82,904.53
1966	11,913.00

Concessions have been made by both parties. It remains for us to decide: (1) petitioner's basis in a terminal facility and in tires and tubes distributed to petitioner on the liquidation of a subsidiary; (2) whether a corporation recognizes income when it distributes in liquidation tires and tubes whose cost it has expensed but whose useful life it has not fully exhausted in its operations.

FINDINGS OF FACT

Petitioner is a corporation organized and existing under the laws of Tennessee. Its principal place of business was at Nashville, Tennessee, when the petition herein was filed.

Petitioner reports income and expenditures according to the accrual method of accounting.

For each of the years in issue petitioner filed a corporation income tax return with the District Director of Internal Revenue, Nashville, Tennessee. For the year 1967 petitioner and its several subsidiaries filed a consolidated income tax return with the Southeast Service Center, Chamblee, Georgia. A consolidated net operating loss wholly attributable to petitioner was reported on that return. Petitioner applied for and on March 15, 1968, was allowed a tentative net operating loss carryback

adjustment reducing petitioner's income tax liability for 1964 and 1965.

On February 28, 1973, respondent mailed to petitioner a statutory notice of deficiencies in Federal income tax for the years in issue. Insofar as these deficiencies are still in controversy they are attributable to respondent's determination that the consolidated net operating loss reported for 1967 and, consequently, the tentative carryback adjustments allowed for 1964 and 1965 were excessive.

During 1967 and for many prior years petitioner was engaged in the motor freight transportation business. On January 3, 1967, petitioner purchased all of the stock of four corporations pursuant to a contract entered into on April 26, 1966. The purchase price was $1,908,190.05.

Among the corporations whose stock was purchased was Service Lines, Inc., (Service) a Tennessee corporation also engaged in the motor freight transportation business. Service remained in operation through February 28, 1967. On the following day it was liquidated and merged into petitioner.

Service was one of several subsidiaries of petitioner which joined the latter in filing the consolidated return for 1967.

Among the assets which were distributed to petitioner by Service on its liquidation was a terminal facility located at 600 9th Avenue South, Nashville, which Service had purchased in 1955 for $255,959.00.

The terminal consisted of an office building, a truck dock and a garage, situated on 52,200 square feet of land zoned for industrial use.

The office building measured 30 x 50 feet, was of brick construction with a stone foundation and plastered walls, and had a full basement.

The truck dock was of steel construction and measured 50 x 120 feet.

The garage was built of brick and measured 35 x 140 feet.

The terminal was centrally located and adequately serviced with water, gas, electricity, telephones, sewerage and other utilities.

The terminal was in use until January 22, 1967, when Service's terminal operations were transferred to a facility owned by petitioner. Petitioner's management contemplated no further use for the terminal and therefore listed it for sale with the Tennessee Real Estate Company shortly after it was vacated.

Eight months before the terminal was listed for sale, it was appraised on behalf of petitioner by J. Campbell Jenkins, the owner of the real estate company. He estimated that as of June 1966, the land was worth $65,250 and the improvements $116,800. Nevertheless, he recommended that the property be listed for sale at $150,000 because he was aware that petitioner wanted to sell it quickly.

Within a week of its being listed for sale, the terminal was damaged by trespassers. Windows were broken, plumbing and electric wiring disarranged, and fire extinguishers sprayed throughout the premises. Similar acts of vandalism occurred throughout the seven months in which the terminal was on the market. In that period it was inspected by five or six prospective purchasers; but because of the condition of the property, none of these expressed an interest in purchasing it. As time passed, retention of the terminal became increasingly burdensome to petitioner, not only because of the expenses incurred in connection with its maintenance but also because of a need for cash which petitioner hoped might be alleviated with the proceeds of the sale of the property. Therefore petitioner advised Jenkins that it would accept less

than $150,000 for the terminal. Shortly after he had been so advised, Jenkins obtained an offer of $100,000 for the terminal from the Stansell Electric Company. In view of the condition of the property, Jenkins considered the offer a satisfactory one. Pursuant to the offer, the terminal was sold to the electric company on August 31, 1967.

While actively engaged in the motor freight transportation business, Service purchased tires and tubes for its own equipment and for equipment which it leased for use in its operations. The cost of procuring tires and tubes to be mounted on equipment already in use was expensed when the tires and tubes were placed in service. The cost of tires and tubes purchased with new equipment was expensed at the time of the purchase.

During the last full year of operations, 1966, Service charged $53,918.03 (net) to expense for tires and tubes.

The average useful life of the tires and tubes purchased by Service was about one year.

When Service was liquidated, it distributed to petitioner 1,638 tires and tubes the cost of which it had previously expensed.[1] At the time of the distribution, 67.5 percent of the useful life of these tires and tubes remained.

OPINION

Issue 1.

The liquidation of Service was a complete liquidation of a subsidiary within the meaning of sections 332 and 334(b)(2).[2] Therefore petitioner's basis in the various

[1] Service may also have distributed to petitioner tires and tubes which may have been in inventory at the time of its liquidation. None of the issues which we are to decide relate to any such tires and tubes. All further references to tires and tubes in this opinion are to those whose cost Service had expensed prior to its liquidation.

[2] All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

assets which it received must be determined by allocating petitioner's adjusted basis in its Service stock among them in proportion to their relative fair market values on the date of distribution, March 1, 1967. Section 1.334-1(c)(4)(viii), Income Tax Regs.

For the purpose of applying section 1.334-1(c)(4)(viii), *supra*, petitioner valued the terminal at $150,000. Respondent determined that on the date it was distributed to petitioner the fair market value of the terminal was less than $100,000. The burden of proving respondent's determination incorrect is on petitioner. *Welch* v. *Helvering*, 290 U.S. 111 (1933).

After the terminal was vacated by Service on January 22, 1967, it was of no further usefulness to petitioner. Petitioner's objective was therefore to sell the terminal as quickly as possible. With this objective in mind, petitioner's real estate agent recommended that the property be listed for sale at $150,000. Shortly after the terminal was listed, it was seriously damaged by trespassers. Windows were broken; plumbing and electric wiring were disarranged; and fire extinguishers were sprayed throughout the premises. These wanton acts discouraged prospective purchasers from becoming interested in the property; and during the seven months in which the terminal remained listed for sale at $150,000, not a single offer of purchase was forthcoming.

As time passed, the need to sell the property became more urgent. Petitioner was in need of the cash that a sale would provide and could ill afford to bear the expense of maintaining so useless an asset as the terminal. Therefore when petitioner was offered $100,000 for the terminal by an unrelated party, an agreement was concluded on the basis of that offer.

Ordinarily, the price at which property is sold in an arm's-length transaction is the best evidence of its fair

market value at the time of the sale. *T. H. Symington & Son, Inc.*, 35 B.T.A. 711, 756 (1937). Petitioner, however, contends that in this instance the sale of the property was dictated by economic necessity and that, consequently, there was inadequate opportunity to negotiate a fair price. Under such circumstances, the price agreed upon might not have been representative of the fair market value of the property. See *Bell's Booteries, Inc.* v. *United States*, 91 F. Supp. 155 (M.D. Tenn. 1948).

In the seven months during which the property was available for sale at $150,000, it was inspected by five or six prospective purchasers. In its damaged condition the property was of interest to none of them at that price. Certainly this indicates that the asking price was well in excess of the fair market value of the property in its damaged condition. Furthermore, when the offer of $100,000 was made, petitioner's real estate agent deemed it well worth accepting. Given these facts, we are satisfied that the value of the selling price as evidence of the fair market value of the terminal has not been impugned because petitioner may have felt compelled by a need for cash to accept the offer of $100,000.

Some incidents of vandalism occurred before the terminal was distributed to petitioner in liquidation; others occurred thereafter. The initial acts of vandalism which occurred before the distribution must have had an adverse effect upon the fair market value of the terminal because of the alterations which they effected in the appearance of the property. Not to be gainsaid, however, is the effect of the damage which was wrought upon the terminal after it was distributed to petitioner. Therefore in determining the fair market value of the property as of the date of distribution, respondent ought not to have presupposed that when the terminal was sold on August 31, 1967, it was worth no less than it had been on the date of distribution six months before.

The extent to which the terminal was damaged after it was distributed was not precisely established at trial. We have therefore to approximate as best we can the extent to which the fair market value of the terminal declined between the date of distribution and the date of sale. Upon due consideration of all the pertinent facts we estimate the amount of the decline to have been $25,000. *Cohan* v. *Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930). Accordingly, we hold that on March 1, 1967, the fair market value of the terminal was $125,000.

When Service purchased tires and tubes to be mounted on equipment used in its operations, it expensed the cost of procuring them when they were placed in service. The cost of tires and tubes purchased on new equipment was expensed at the time of the purchase. These costs were charged to expense rather than capitalized on the assumption that the average useful life of the tires and tubes was one year or less.

When Service was liquidated, it distributed to petitioner 1,638 tires and tubes, the cost of which it had previously expensed. For the purpose of applying section 1.334-1 (c) (4) (viii), *supra*, petitioner valued these tires and tubes at $94,940.

During 1966, the last full year of its operations, Service charged $53,918.03 (net) to expense in respect of tires and tubes. In view of this, respondent determined that the value assigned by petitioner to the 1,638 tires and tubes was excessive.

There is nothing in the record to indicate that the cost of tires and tubes increased significantly between the time when Service purchased the tires and tubes whose cost it charged to expense in 1966, and the date on which it was liquidated. On the date of Service's liquidation, 67.5 percent of the useful life of the 1,638

tires and tubes remained. We would therefore be inclined to hold that on the liquidation of Service the fair market value of these tires and tubes was $36,394.67, *Colonial Fabrics* v. *Commissioner*, 202 F.2d 105 (2d Cir. 1953), affg. a Memorandum Opinion of this Court, cert. denied 346 U.S. 814 (1953), unless, as petitioner contends, the average useful life of the tires and tubes which it received was substantially in excess of one year when Service put them into use. This possibility is belied by the testimony of Service's former tire servicemen to the effect that most tires and tubes have a useful life of approximately one year.

We therefore hold that on March 1, 1967, the fair market value of the tires and tubes in question was $36,394.67.[3]

Issue 2.

If the useful life of items purchased for use in the production of income is sufficiently brief that the cost of procuring them may be expended,[4] then ordinarily their cost is expensible in a taxable year to the extent the items are actually consumed in operations during that year. *Spiegal, May, Stern Co.* v. *United States*, 37 F.2d 988 (Ct. Cl. 1930). A taxpayer engaged in the motor freight transportation business may, however, expense the cost of tires and tubes purchased for use in its operations before they are consumed, provided the average useful life of the tires and tubes is one year or less. See Rev. Rul. 59-249, 1959-2 C.B. 55; and Rev. Rul. 73-357, 1973-2 C.B. 40.

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[3] All outstanding issues of fair market value having been resolved, petitioner's basis in the various assets which it received on the liquidation of Service may be computed under Rule 155, Tax Court Rules of Practice and Procedure.

Respondent concedes that petitioner is entitled to deduct on the consolidated return filed for 1967 the basis allocated to the tires and tubes.

[4] See section 1.446-1(a) (4) (ii), Income Tax Regs.

Certain of the tires and tubes whose cost Service expensed were not fully consumed in its operations. Rather they were distributed by Service in liquidation when a substantial portion of their useful life had not been exhausted. We must decide if Service recognized income on the distribution of these tires and tubes under the tax benefit rule. We have not addressed ourselves to this issue previously. See *Estate of David B. Munter*, 63 T.C. 663, 677 (1975).

The tax benefit rule provides that an item properly offset against gross income in determining one year's tax liability is includible in gross income when it is recovered in a subsequent year. *Alice Phelan Sullivan Cooperation* v. *United States*, 381 F.2d 399, 401-402 (Ct. Cl. 1967). Before proceeding to consider whether the rule is applicable in the case now before us we note that so far as can be ascertained from the record, the costs incurred by Service in procuring the tires and tubes which it distributed in liquidation were offset against Service's gross income in determining its tax liability.[5]

Relying on *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837, 839-840 (9th Cir. 1963), affg. 36 T.C. 1027 (1961), petitioner contends that Service made no recovery in respect of the tires and tubes which it distributed in liquidation because *in actuality* it neither received nor became entitled to receive money or property in exchange for them; and that therefore the tax benefit rule is inapplicable in this instance.[6]

[5] Certainly the burden of proving the contrary would be upon petitioner. *Welch* v. *Helvering*, 290 U.S. 111 (1933).

[6] In deciding *South Lake Farms, Inc.*, 36 T.C. 1027 (1961), this Court did not address itself to the issue of whether there had been a recovery for purposes of the tax benefit rule. That issue was dealt with only by the United States court of appeals for the ninth circuit; and it is on the decision of that court that petitioner relies.

In our opinion the understanding of "recovery" upon which the decision of the United States court of appeals for the ninth circuit in *South Lake Farms, Inc.*, rests is unduly restrictive. It is well established, for example, that an item of expenditure that has been properly accrued but not paid is deemed to be recovered when liability for the item terminates. *Bear Manufacturing Company* v. *United States*, 430 F.2d 152 (7th Cir. 1970), cert. denied 400 U.S. 1021 (1971); *Mayfair Minerals, Inc.*, 56 T.C. 82 (1971), affd. per curiam 456 F.2d 622 (5th Cir. 1972). This leads us to conclude that for purposes of the tax benefit rule, a taxpayer may have recovered an item previously expensed although *actually* he has neither received nor become entitled to receive money or property. See *Estate of William H. Block*, 39 B.T.A. 338, 341 (1939), affd. sub nom. *Union Trust Co.* v. *Commissioner*, 111 F.2d 60 (7th Cir. 1940).

Service was permitted to expense the cost of the tires and tubes which it purchased, on the assumption that their useful life would be fully exhausted in its operations. Once Service had expensed their cost, the tires and tubes were therefore deemed to have been fully consumed in its operations for purposes of Federal income taxation whatever their fair market value may have been. If, having expensed the cost of the tires and tubes Service subsequently treated them as property having a fair market value in a transaction of consequence in the scheme of Federal income taxation, it would therefore necessarily be deemed to have received tires and tubes identical to them immediately prior to that transaction. *Anders* v. *United States*, 462 F.2d 1147, 1149 (Ct. Cl. 1972), cert. denied 409 U.S. 1064 (1972); *Spitalny* v. *United States*, 430 F.2d 195, 197-198 (9th Cir. 1970).

When Service was liquidated, among the property which it distributed to petitioner, its sole shareholder, were tires and tubes having a fair market value of

$36,394.67. Service had previously expensed the cost of these items. It must therefore be deemed to have received immediately prior to its liquidation, tires and tubes equal in value to those which it distributed.

Service's receipt of tires and tubes which is deemed to have occurred for purposes of Federal income taxation, was occasioned by its distribution of property in liquidation. Section 336 provides that a corporation shall not recognize gain or loss on the distribution of property in liquidation. The receipt of the tires and tubes, however, is an event of independent significance for purposes of Federal income taxation and is therefore not subject to section 336. *Hempt Bros., Inc.* v. *United States*, 490 F.2d 1172, 1180 (3d Cir. 1974).

We therefore hold that under the tax benefit rule Service had to include in gross income on its liquidation the lesser of the fair market value of the tires and tubes which it distributed or the portion of their cost attributable to their useful life remaining at the time of the distribution. *Spitalny* v. *United States*, *supra*, at 198; *Alice Phelan Sullivan Corporation* v. *United States*, *supra*.

There is no indication in the record of significant fluctuation in the cost of tires and tubes. In this instance, therefore, the portion of the cost of the tires and tubes attributable to their remaining useful life is equal to their fair market value at the time of the distribution, $36,394.67; and it is that amount which Service had to include in gross income on its liquidation.[7]

[7] Our holding pertains solely to the distribution in liquidation of property whose cost has previously been expensed. We point this out to preclude inapposite analogies to the distribution in liquidation of fully depreciated property. *Commissioner* v. *Anders*, 414 F.2d 1283, 1288 (10th Cir. 1969), revg. 48 T.C. 815 (1967), cert. denied, 396 U.S. 958 (1969). See also the concurring opinion of Judge Tannenwald in *Estate of David B. Munter*, 63 T.C. 663 at 679-680 (1975).

At this juncture we would take note of the decision of the Supreme Court in *Nash* v. *United States*, 398 U.S. 1 (1970).

Under *Nash* an accrual basis corporate taxpayer which provides for bad debt losses with respect to its accounts receivable by maintaining a reserve account would not be required to include the reserve in gross income if it distributed the receivables in liquidation. The decision presupposes that the fair market value of the receivables distributed would equal their net worth, i.e. their face value less the amount in the reserve for bad debts. The case now before us, however, is better analogized to the situation in which the fair market value of the receiveables exceeds their net worth. *Nash* implies that in such a case the reserve would be includible in the gross income of the liquidating corporation to the extent the fair market value of the receivables exceeded their net worth. See 398 U.S. at 4-5. See also *Citizens' Acceptance Corporation* v. *United States*, 462 F.2d 751 (3d Cir. 1972). Our holding in the case now before us is therefore wholly consistent with *Nash*.

Reviewed by the Court.

Decision will be entered under Rule 155.

SIMPSON, *J.*, concurring: Although I agree with the Court's conclusions in this case, I wish to emphasize that there was a "recovery" in this case because the liquidation was of the type described in section 334(b)(2) and was part of a plan for the acquisition of the assets of Service.

Section 334(b)(2) provides that under certain circumstances, the parent corporation's adjusted basis in the stock of its subsidiary is substituted as the basis of the property received from the subsidiary in a section 332 liquidation. The parent is treated as though it had purchased the subsidiary's assets instead of its stock. S. Rept. No. 1622, 83d Cong., 2d Sess. 257 (1954); see *Kimbell-Diamond Milling Co.*, 14 T.C. 74, 80 (1950), affd. per curiam 187 F. 2d 718 (5th Cir. 1951), cert. denied 342 U.S. 827 (1951). Under such circumstances, I agree that Service "recovered" a reduction previously taken.

By our holding in this case, we are expressing no position concerning the tax consequences when property is distributed in other types of liquidations.

TANNENWALD, *J.*, dissenting: I disagree with the majority's application of the tax benefit rule to the facts presented herein on the simple ground that there was no recovery within the meaning of the third prong of that rule which I set forth in my concurring opinion in *Estate of David B. Munter*, 63 T.C. 663, 679 (1975): "(1) An amount previously deducted, (2) which resulted in a tax benefit, and (3) was *recovered* during the taxable year in issue." (Emphasis added). The majority rests its decision on the fiction that petitioner "must * * * be deemed to have received immediately prior to its liquidation, tires and tubes equal in value to those which it distributed." In other words, the act of disposition itself becomes the equivalent of receipt of the property disposed of, without any corresponding present benefit. I had thought that the use of fictions as a basis for applying the tax benefit rule had been abandoned. *Nash* v. *United States*, 398 U.S. 1 (1970). Compare *John T. Stewart III Trust*, 63 T.C. 682 (1975). See also *Estate of David B. Munter, supra*, 63 T.C. at 680 (concurring opinion).

In every case cited by the majority, in which the tax benefit rule has been applied, there was a present economic benefit, either by way of an actual receipt of funds or a release of a liability resulting in an increase in the taxpayer's net worth. In both *Bear Manufacturing Company* v. *United States*, 430 F.2d 152 (7th Cir. 1970), and *Mayfair Minerals, Inc.*, 56 T.C. 82 (1971), affd. per curiam 456 F.2d 622 (5th Cir. 1972), the taxpayer gave recognition in the taxable year to the termination of a liability, which had formed the basis of a deduction in a prior year, by transferring the amount of the liability to surplus, i.e. increasing its net worth. This act of transfer, which made "the money which the [previous] accruals represented * * * available for its general use" (see *Mayfair Minerals, Inc., supra*, 56 T.C. at 87), was

held to be the taxable event, i.e., there was a present economic benefit.[1]

The only apparent source of authority for a broader reading of the word "recovery" is *Estate of William H. Block*, 39 B.T.A. 338, 341 (1939), affd. sub nom. *Union Trust Co.* v. *Commissioner*, 111 F.2d 60 (7th Cir. 1940), wherein it was said:

> Income tax liability must be determined for annual periods on the basis of facts as they existed in each period. When recovery or *some other event which is inconsistent with what has been done in the past* occurs, adjustment must be made in reporting income for the year in which the change occurs. (Emphasis added).

Since that case involved an actual recovery in the form of a receipt by the taxpayer of a "refund of the taxes which formed a basis for deductions from its income in prior years," 39 B.T.A. at 340, the above-emphasized portion of the Board's opinion is clearly dictum. Moreover, the Board's language can be read to embrace those situations where there was no recovery in the sense of an actual receipt of funds by the taxpayer but where there was an "event" which could be equated with recovery such as the termination of a liability, thereby increasing net worth, such as occurred in *Mayfair Minerals, Inc., supra.*

To the extent that the majority reads the language of *Block* to sanction the application of the tax benefit rule where the only event is the cessation of need for the prior deduction, its approach is directly contrary to that taken

[1] It should be noted that the expensing of the tires and tubes in previous years in and of itself created no asset or liability which was capable of transfer or whose disposition would have affected the petitioners' net worth. Cf. *Nash* v. *United States*, 398 U.S. 1, n. 4 (1970); *Argus, Inc.*, 45 T.C. 63, 69-70 (1965).

in *Nash* v. *United States, supra*, where the Supreme Court categorically rejected the concept that the "end of 'need' [was] synonymous with 'recovery' in the meaning of the tax benefit rule." See 398 U.S. at 3. Indeed, the majority recognizes the difficulty presented by *Nash* and attempts to distinguish that holding on the ground that the Supreme Court indicated the possibility of applying the tax benefit rule where the fair market value of the property received by the taxpayer exceeds the adjusted basis of the property given up and the taxpayer had obtained a tax benefit from the prior deduction of all or part of the original cost. But, such a distinction assumes the critical factor, namely, that there was a recovery, i.e., that the taxpayer received something. In distinguishing *Nash*, the Court of Appeals in *Citizens' Acceptance Corporation* v. *United States*, 462 F.2d 751, 756-757 (3d Cir. 1972), cited by the majority to support its rationalization of *Nash*, emphasized this very factor. See also *Bishop* v. *United States*, 324 F.Supp. 1105, 1111-1112 (M.D. Ga. 1971). Unlike the receipt of cash or other property or the release from a liability, a liquidating distribution does not cause a corporate taxpayer to realize any economic benefit. Petitioner herein received only its own stock in return for the distributed property; the value of such stock upon the corporation's cessation of business and distribution of property is nil. See *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837, 839 (9th Cir. 1963). See also O'Hare, "Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders," 27 Tax L. Rev. 215, 233-236 (1972).

Two aspects of the instant situation obviously influenced the majority in reaching their conclusion: (1) the feeling that, unless the tax benefit rule is applied, petitioner will have the equivalent of a double deduction and (2) the need to have parity between the applications of

sections 336 and 337,[2] a problem which I dealt with extensively in my concurring opinions in *Estate of David B. Munter*, *supra*, and *John T. Stewart III Trust*, *supra*.

As to the first aspect, since the petitioner realized nothing upon its own liquidation, it cannot be said to have enjoyed any "double deduction." Compare *Bishop* v. *United States*, *supra*, where, absent the tax benefit rule, a corporation would have twice enjoyed tax benefits where it had realized, but had not recognized, gain from section 337 liquidation sales of inventory and where the cost of the items sold had been deducted from income in previous years under the farm-price inventory method of accounting. See also *United States* v. *Skelly Oil Company*, 394 U.S. 678, 684 (1969); *Winer* v. *Commissioner*, 371 F.2d 684, 686 (1st Cir. 1967).

To the extent that there is a double deduction herein it arises from the fact that the distributee corporation appears entitled to expense its stepped-up basis in the tires and tubes. But any advantage to the distributee corporation by reason of a section 334(b)(2) stepped-up basis cannot be charged to the distributor-liquidating corporation. The provisions of section 334(b)(2) merely prescribe the basis of property in the distributee's hands; that they treat the parent as though it has purchased the assets of the subsidiary does not mean that they alter the tax consequences of a liquidation pursuant to other statutory sections, e.g., by imputing a sale of the property to the liquidated corporation. See *Supreme Investment Corporation* v. *United States*, 468 F.2d 370 (5th Cir. 1972); *Bijou Park Properties, Inc.*, 47 T.C. 207, 214 (1966); see also Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, (3d ed.) par. 11.44 (automatic operation of section 334(b)(2)). The tax

[2] It should be noted that the taxability of the corporation is determined under sections 336 and 337, whether the liquidation is taxable or tax-free to the recipients under sections 331 through 333.

benefit rule does not require one taxpayer to assume a tax liability for benefits accruing to another taxpayer. *Commissioner* v. *South Lake Farms, Inc.*, *supra*. Cf. *Peter Pan Seafoods, Inc.* v. *United States*, 417 F.2d 670 (9th Cir. 1969).

As far as parity between sections 336 and 337 is concerned, the courts have thus far refrained from embracing any absolute rule. See *Commissioner* v. *South Lake Farms, Inc.*, *supra*, 324 F.2d at 839; *John T. Stewart III Trust*, *supra*, 63 T.C. at 693; *Estate of David B. Munter*, *supra*, 63 T.C. at 677. Moreover, it has been pointed out that complete parity between these two sections can never exist because of specific limitations contained in section 337. See *Midland-Ross Corp.* v. *United States*, 485 F.2d 110, 117-118 (6th Cir. 1973). See also Bittker & Eustice, *supra*, par. 11.65. It cannot be gainsaid that section 337 was enacted to eliminate the judicially created formalisms which made tax consequences turn on a determination whether a corporation in the process of liquidation or its shareholders made the sale of the assets. See S. Rept. No. 1622, 83d Cong., 2d Sess. 48-49 (1954); H. Rept. No. 1337, 83d Cong., 2d Sess. 38-39 (1954). By way of contrast, section 336 represented a legislative confirmation of the longstanding judicial doctrine that a corporation generally does not realize income from a distribution of its assets in kind to its shareholders. See S. Rept. No. 1622, *supra*, at 46; H. Rept. No. 1337, *supra*, at 37-38. Cf. *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935). But it does not follow from the fact that section 337 was intended generally to relieve the liquidating corporation of taxability on any gain from the sale of its assets that Congress intended to impose a tax liability (which would not otherwise have been incurred) upon a corporation liquidating in kind under section 336, simply because such liability would have been realized upon a sale of assets otherwise qualifying for nonrecognition under section 337. Section

337 was designed to be a shield for taxpayers and not a sword to be used against them in applying other sections of the Code. I am not unmindful of the fact that there may be a trap for the unwary to the extent that a dichotomy develops between the two sections. But, as I see it, this inheres in the statutory and judicial structure. Compare *Waltham Netoco Theatres, Inc.*, 49 T.C. 399 (1968), affd. 401 F.2d 333 (1st Cir. 1968).

In analyzing the issue before us, I think it is of some significance that the recapture of depreciation deductions which Congress has seen fit to impose in corporate liquidations (see section 1245 and section 1.1245-4(c), Income Tax Regs.) does not compel recovery of expensed items under like circumstances. In fact, it appears that section 1245 does not extend to expensed as distinguished from depreciable property, cf. *Coca-Cola Bottling Co. of Baltimore* v. *United States*, 487 F.2d 528 (Ct. Cl. 1973), a position which is in accord with the concept that a deduction for ordinary and necessary business expenses is not the same animal as a deduction allowed for depreciation. See *Pittsburgh Athletic Co.*, 27 B.T.A. 1074 (1933), affd. 72 F.2d 883 (3d Cir. 1934).[3]

If we are to be guided by legislative expression, let it be by section 111, the statutory tax benefit rule. This provision excludes from gross income the amount of a prior deduction later recovered to the extent the earlier deduction did not result in a tax benefit. This provision requires an actual economic recovery and its thrust in terms of the tax benefit rule is one of limitation; it was enacted to "harness the 'benefit theory' to a standard formula which could be applied with reasonable uniformity." See 1 Mertens, Law of Federal Income Taxation,

[3] Compare section 1.162-3, Income Tax Regs., with sections 1.263(a)-1 and 1.263(a)-2, Income Tax Regs. See generally *Welch* v. *Helvering*, 290 U.S. 111, 113 (1933).

section 7.34, n. 38 (Malone rev. 1974).[4] To permit the word "recovery" to take on Procrustean attributes would clearly not serve this purpose.

In sum, I simply cannot find that element of "recovery" herein which the application of the tax benefit rule demands. Similarly, I cannot bring myself to dispense with the "recovery" requirement (or alternatively to find a fictional "recovery") in order to apply that rule and impute a taxable event to a corporate liquidation in kind under circumstances where such taxability has heretofore not been considered to exist. In this connection, it is interesting to note that this Court, in the past, has refused to activate "the abstract notion of tax benefit" to require a taxpayer to include in income gratuitously cancelled interest on his indebtedness, notwithstanding the fact that such taxpayer had accrued and deducted such interest in prior years. *Hartland Associates*, 54 T.C. 1580, 1586 (1970).

To the extent that petitioner expensed tires and tubes purchased in the year of liquidation, an adjustment should be made in petitioner's deductions for that year under section 446(b). *Spitalny* v. *United States*, 430 F.2d 195, 198 (9th Cir. 1970); *Estate of David B. Munter*, *supra*, 63 T.C. at 682 (concurring opinion).

DRENNEN, IRWIN, STERRETT, QUEALY, GOFFE and HALL, *JJ.*, agree with this dissent.

[4] See also H. Rept. No. 2333, to accompany H.R. 7378 (Pub. L. 753), 77th Cong., 2d Sess. 45, 69-71 (1942).

APPENDIX B

No. 76-2496

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

TENNESSEE-CAROLINA TRANSPORTATION, INC.,
Plaintiff-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Defendant-Appellee.

APPEAL FROM THE UNITED STATES TAX COURT

Decided and Filed August 21, 1978

Before: WEICK, CELEBREZZE and KEITH, Circuit Judges.

CELEBREZZE, J., delivered the opinion of the Court, in which KEITH, J., joined. WEICK, J., filed a separate opinion, concurring in part and dissenting in part.

CELEBREZZE, Circuit Judge. The principal issue presented on appeal is whether the tax benefit rule [1] is ap-

[1] The tax benefit rule provides that if an amount which was deducted from gross income in a prior year is recovered in a later year then the amount recovered is included in gross income in the later year. *Alice Phelan Sullivan Corp.* v. *United States*, 381 F.2d 399 (Ct. Cl. 1967). *See generally* 1. J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 7.34. (1974 ed.). The rule is of judicial origin and has been codified in part in Internal Revenue Code § 111. *Id.*

plicable to a corporate liquidation governed by Internal Revenue Code § 336. We hold that it is and affirm the decision of the Tax Court.[2]

Taxpayer, Tennessee-Carolina Transportation, Inc., is a Tennessee corporation engaged in the motor freight transportation business. Pursuant to a contract entered into in 1966, taxpayer purchased in January, 1967, all of the capital stock of Service Lines, Inc. (Service). Service was also engaged in the motor freight transportation business. Service was operated temporarily as a wholly owned subsidiary of taxpayer until March 1, 1967, when it was liquidated and merged into taxpayer. The liquidation consisted of Service distributing all of its assets to taxpayer, its sole shareholder, in exchange for its stock, which was then retired.[3]

Among the assets distributed to taxpayer by Service were truck tires and tubes which Service had purchased for its own use. The expected useful life of these tires and tubes was approximately one year, so Service had properly fully deducted (expensed) their cost when purchased. Pursuant to Internal Revenue Code § 334(b)(2), taxpayer claimed a stepped-up basis in the assets received from Service by allocating the purchase price of the Service stock proportionately to the assets received based on their respective fair market value. Taxpayer thereafter fully deducted the amount so allocated to the tires and tubes as a business expense in the consolidated income tax return it filed with Service for 1967.[4]

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[2] We also affirm the Tax Court on the issue of valuation raised by taxpayer for the reasons set forth in the opinion of the Tax Court.

[3] Internal Revenue Code §§ 332 and 336 provide that, as general rules, "no gain or loss shall be recognized" to taxpayer or Service, respectively, by virtue of this merger.

[4] The 1967 consolidated return showed a net operating loss, wholly attributable to taxpayer, which was tentatively carried back to reduce taxpayer's tax liability for prior years.

The Commissioner of Internal Revenue claimed that the 1967 consolidated return underreported income.[5] The only aspect of this determination now at issue relates to the Commissioner's contention that the tax benefit rule required that Service include as income in 1967 the value of the tires and tubes distributed to taxpayer.[6]

The full Tax Court upheld the Commissioner's position and found a deficiency in income taxes due from taxpayer. 65 T.C. 440 (1975).[7] The court applied the tax benefit rule to require Service to include in its 1967 income an amount equal to the value of the previously expensed but not fully consumed tires and tubes which were distributed to taxpayer. The court rejected as "unduly restrictive" the holding in *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963), which found the tax benefit rule inapplicable to corporate liquidations governed by § 336.

Taxpayer argues on appeal that the tax benefit rule operates only when there is a "recovery" of an amount previously deducted. It contends that Service had no "recovery" of its expense deduction for the tires and tubes since it distributed them directly to taxpayer and received nothing in exchange. We reject taxpayer's con-

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[5] The Commissioner determined that the 1967 net operating loss was excessive and, consequently, that the tentative loss carryback was excessive.

[6] Service's 1967 income was reported on the consolidated 1967 return, so increasing its income effectively reduced the taxpayer's net operating loss. The Commissioner conceded that taxpayer was allowed to fully deduct in 1967 the amount allocated to the tires and tubes, which amount was contested, *see* note 1, *supra*, so the increase in Service's income simply cancelled out taxpayer's deduction and reduced the net operating loss by the amount attributable to the tires and tubes.

[7] One judge filed a concurring opinion and seven judges dissented. *See* O'Hare, *Application of Tax Benefit Rule in New Case Threatens Certain Liquidations*, 44 J. TAX. 200 (1976).

tentions inasmuch as they would produce an unnecessary disparity between liquidations governed by § 336 and those governed by Internal Revenue Code § 337. Taxpayer's position also asserts a wooden interpretation of the tax benefit rule which we find inappropriate.

The liquidation of Service was effected by distributing Service's assets to its sole shareholder, taxpayer, in exchange for its stock, which was then retired. As to Service, the liquidation was thus governed by the general nonrecognition provisions of § 336.[8] An alternative method of accomplishing the same result would have been for taxpayer to buy all of Service's assets at the same price it paid for Service's stock, with Service then liquidating and distributing the proceeds of the sale to its shareholders. This corporate liquidation would have been governed by the general nonrecognition provisions of § 337.[9] The business consequences of either alternative would have been identical—Service liquidated, Service's shareholders in possession of the proceeds of the sale in exchange for retirement of their stock, and the taxpayer in possession of Service's assets with a basis equal to their purchase price.

Taxpayer concedes that if the liquidation of Service had been governed by § 337 the tax benefit rule would apply, overriding the general nonrecognition rule of

[8] Internal Revenue Code § 336:

> Except as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.

[9] Internal Revenue Code § 337(a):

> (a) General rule.—If, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

§ 337 and requiring that Service recognize as ordinary income the amount previously expensed. *Anders* v. *United States*, 462 F.2d 1147 (Ct. Cl.), *cert. den.* 409 U.S. 1064 (1972); *Spitalny* v. *United States*, 430 F.2d 195 (9th Cir. 1970); *Commissioner* v. *Anders*, 414 F.2d 1283 (10th Cir. 1969); *S. E. Evans, Inc.* v. *United States*, 317 F.Supp. 423 (W.D. Ark. 1970). There is no reason in either the statute or tax policy for reaching a different result in this case merely because Service and taxpayer chose a § 336 liquidation. In a case applying the assignment of income doctrine to overcome the general nonrecognition provisions of § 337 this court noted that § 336 and § 337 liquidations cannot always be treated alike for tax purposes due to some provisions that are unique to § 337. *Midland-Ross Corp.* v. *United States*, 485 F.2d 110, 117-18 (6th Cir. 1973).[10] *Midland-Ross* also made it clear, however, that as a general rule § 336 and § 337 liquidations were to be treated alike. *Id.* at 114 ("parity of tax treatment at the corporate level") *and* 117 ("purpose of establishing a parity between Sections 336 and 337"). Section 336 liquidations are to be treated like § 337 liquidations as a general rule unless some peculiar provision of § 337 justifies disparate treatment.[11] No such statutory justification exists here.

There is no support for the contention that § 337 was "designed to be a shield for taxpayers and not a sword

[10] In particular, we noted § 337(b)'s unique denial of nonrecognition to gain or loss from sales in the ordinary course of business during the relevant twelve-month period.

[11] *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.62, p. 11-52 and ¶ 11.65, p. 11-72 (3d ed. 1971) (hereinafter BITTKER). This authority notes that applying the tax benefit rule to § 336 liquidations is the better result. It also suggests that courts may be hesitant to apply the rule in this context, citing, *inter alia*, *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963), but we believe that we should not hesitate to avoid inequities in the tax laws which are not specifically mandated by Congress.

to be used against them," as contended by the dissenters here and in the Tax Court. Section 337 "was designed to eliminate the formalistic distinctions recognized and perhaps encouraged by the decisions in *Court Holding* and *Cumberland.*[12]" *Central Tablet Mfg. Co.* v. *United States*, 417 U.S. 673, 682 (1974). Taxpayer and the dissent would have us resurrect these precise formalistic distinctions.

Taxpayer seems to realize the disparity its position would sanction but nevertheless argues that the tax benefit rule is inapposite to § 336 since it cannot conceptualize any "recovery" by Service of the previously deducted amount. There are several answers to this contention.

First, there need not be an actual physical "recovery" of some tangible asset or sum in order to apply the tax benefit rule.[13] The tax benefit rule should be applied flexibly in order to counteract the inflexibility of the annual accounting concept which is necessary for administration of the tax laws. The rule should apply whenever there is an actual recovery of a previously deducted amount *or* when there is some other event in-

[12] The cases referred to are *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945) and *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950). *Court Holding* "held that a liquidating corporation could not escape taxation on the gain realized from the sale of its sole asset if the corporation itself had arranged the sale prior to liquidation and distribution of the asset to the shareholders. This was so even though the sale was consummated after the distribution." 417 U.S. at 679. *Cumberland* "reached exactly the opposite conclusion in a case where the shareholders, rather than the corporation, had negotiated the sale of the distributed assets and, prior to the corporation's liquidation, had been in touch with the purchaser and had offered to acquire the property and sell it to the purchaser." 417 U.S. at 680. *See generally* 417 U.S. at 678-83.

[13] We reject the contrary holding in *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963). *See* Rev. Rul. 77-67, 1977-1 C.B. 33; Rev. Rul. 74-396, 1974-2 C.B. 106.

consistent with that prior deduction. *See Block* v. *Commissioner*, 39 B.T.A. 338, 340-41 (1939), *aff'd sub nom. Union Trust Co.* v. *Commissioner*, 111 F.2d 60 (7th Cir.), *cert. den.* 311 U.S. 658 (1940). Here the transfer to taxpayer with a stepped-up basis, pursuant to § 334 (b)(2), of the tires and tubes which had a substantial useful life remaining was inconsistent with the prior expensing of them, which indicated they had been or would be totally used up by Service. This inconsistency is enough to invoke the tax benefit rule.[14]

Second, even if a "recovery" is required to apply the tax benefit rule, there was such a recovery here. When the tires and tubes were expensed by Service they were, in contemplation of the tax laws, completely consumed. They had a zero basis and were considered a nonentity, but only in contemplation of their actual consumption by Service. At the time of the liquidation, an event of significance in the tax laws, they were transferred to taxpayer as a usable entity. This transfer belied the assumption that they would be wholly consumed by Service. Thus, in order for Service to be able to transfer them to taxpayer they must be deemed to have been recovered by Service at that time, as the Tax Court held. Taxpayer objects to this, claiming it is a "fictional" recovery. In a sense it is fictional but certainly no more so than the initial fiction that the tires and tubes would be completely consumed by Service in about one year in order to justify their being expensed. Taxpayer cannot equitably argue that Service should have the benefit of fictionally converting the tires and tubes into a nonentity (by expensing them) yet not have the burden of having

[14] Moreover, by taking advantage of § 334(b)(2)'s stepped-up basis provision, taxpayer is employing a statutory device which recognizes that, in some circumstances, a purchase of stock is essentially a purchase of assets, thus giving the assets their pro rata share of the basis of the stock. This is wholly inconsistent with taxpayer's assertion that Service had no "recovery".

them fictionally reconverted into tangible property (by applying the tax benefit rule). *Spitalny* v. *United States*, 430 F.2d 195, 198 (9th Cir. 1970).

Third, again assuming there need be an actual "recovery" in order to apply the tax benefit rule, there was a recovery here in another sense. Service received its own stock in exchange for the assets transferred to taxpayer. It is true that this stock had no value *after* the liquidation was completed, but it had considerable value *at the time it was returned* to Service. This is enough to satisfy any need for a "recovery" by Service in order to apply the tax benefit rule.[15]

United States v. *Nash*, 398 U.S. 1 (1970), is relied upon by taxpayer but does not support its position. *Nash* involved a § 351 incorporation in which accounts receivable were transferred by the taxpayers to newly formed corporations. The taxpayers, before incorporation, had established a bad debt reserve and taken appropriate deductions. The Supreme Court held that the taxpayers did not "recover" the amount of the bad debt reserve upon incorporation. The reason, however, was that they had only transferred the *net value* of the receivables (face amount less bad debt reserve) to the new corporations and had received in exchange stock worth that net value. *Id.* at 4. Thus, unlike the instant case, in *Nash* the taxpayers did *not* transfer an item (or any portion thereof) which had been the subject of a prior deduction, but rather transferred only what was left after the deduction. Here, Service clearly transferred items which had been the subject of prior deductions. Furthermore,

[15] This is consistent with the general rule expressed in Internal Revenue Code § 331(a) that amounts distributed on liquidation are to be treated as payment in exchange for the retired stock. While retirement of stock on liquidation is not completely analogous to a sale, the tax laws have treated this as a sale almost continuously since 1924. BITTKER ¶ 11.01, p. 11-2 & 3.

in *Nash* the bad debt reserve deduction reflected business reality since only the net value of the receivables could realistically be collected; here the expense deduction did not reflect business reality since the tires and tubes were not in fact consumed by Service. *Nash* simply does not stand for the proposition, for which it is cited by taxpayer, that the tax benefit rule only applies in the case of an actual physical, as opposed to "fictional," recovery of a previously deducted amount.

The fundamental inequity of the result urged by taxpayer is that it would treat like cases differently. Sometimes an express statutory command necessitates this but that is not the case here. Indeed, § 337 was meant to work precisely the opposite result and do away with most "formalistic distinctions" between liquidations involving distributions in kind and sales of assets. We refuse to elevate form over substance by reviving technical differentiations put to rest in 1954 with the adoption of § 337.[16]

The judgment of the Tax Court is affirmed.

[16] *See generally* O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 TAX L. REV. 215 (1972). Therein the author suggests that a statute may be necessary to reach the result announced herein, but we feel a statute is not necessary for the reasons set forth above. Rather, we agree with the author's conclusion that refusal to apply the tax benefit rule to cases like this one "resurrects a discrepancy in tax treatment between preliquidation and post liquidation sales which section 337 was intended to eliminate." *Id.* at 240. We also note that refusal to apply the tax benefit rule here would result in "another tax trap . . . for the unwary" which would be "questionable as a matter of tax policy." *Id.* at 245.

WEICK, Circuit Judge, concurring and dissenting. I concur in the majority's judgment with respect to the valuation of the tires and tubes, but dissent from that portion of the judgment which holds the tax benefit rule applicable to a liquidation in kind under 26 U.S.C. § 336.

The tax benefit rule provides that "if an amount deducted from gross income in one taxable year is recovered in a later year, the *recovery* is income in the later year." [Emphasis added.] 1 Mertens, Law of Federal Income Taxation § 7.34, at 111 (rev. ed. 1974).

The rule is one of judicial origin. Although not expressly stated in the Internal Revenue Code, it has received indirect statutory recognition specifically with respect to bad debts, prior taxes, and delinquency amounts, in 26 U.S.C. § 111. The rule of the statute has been broadened by the Treasury Regulations to include the recovery of "all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years . . . ." Treas. Reg. § 1.111(a).

In order to sustain the application of the tax benefit rule to the facts of this case, the majority holds that an actual economic recovery is not required for an application of the rule; rather, it concludes that the tax benefit rule is apposite in situations in which "there is some other event inconsistent with [the] prior deduction." This reasoning stems from the following language used by the Tax Court in *Estate of Block*, 39 B.T.A. 338, 341 (1939), *aff'd sub nom., Union Trust Co.* v. *Commissioner*, 111 F. 2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940):

> Income tax liability must be determined for annual periods on the basis of facts as they existed in each period. When recovery or *some other event which is inconsistent with what has been done in the past* occurs, adjustment must be made in reporting income for the year in which the change occurs. [Emphasis added]

This statement, however, is nothing more than dictum. In *Estate of Block*, *supra*, there was an actual economic recovery of the prior tax benefit by way of the refund of federal estate taxes, which taxes had formed the basis of the previous deduction.

Neither the majority, the majority of the Tax Court,[1] nor the Commissioner has cited a single case in which the tax benefit rule has been applied solely on the basis of the occurrence of an event which was inconsistent with a previous deduction. To the contrary, the salient feature of every case cited by them, in which the rule was applied, is the presence of an actual economic recovery by the taxpayer, either (1) by way of receipt of funds, *e.g.*, *Citizens' Acceptance Corp.* v. *United States*, 462 F.2d 751 (3d Cir. 1972); *Anders* v. *United States*, 462 F.2d 1147 (Ct. Cl.), *cert. denied*, 409 U.S. 1064 (1972); *Spitalny* v. *United States*, 430 F.2d 195 (9th Cir. 1970); *Alice Phelan Sullivan Corp.* v. *United States*, 381 F.2d 399 (Ct. Cl. 1967); or (2) by way of a discharge of an accrued liability resulting in an increase in the taxpayer's net worth, *e.g.*, *Mayfair Minerals, Inc.* v. *Commissioner*, 456 F.2d 622 (5th Cir. 1972); *Bear Mfg. Co.* v. *United States*, 430 F.2d 152 (7th Cir. 1970), *cert. denied*, 400 U.S. 1021 (1971); *North Am. Coal Corp.* v. *Commissioner*, 97 F.2d 325 (6th Cir. 1938). Furthermore, the regulations under the statutory tax benefit rule, 26 U.S.C. § 111, require that there be an actual recovery of the prior tax benefit. Treas. Reg. § 1.111-1.

In *United States* v. *Nash*, 398 U.S. 1 (1970), the Supreme Court refused to apply the tax benefit rule to a situation in which there was no actual economic recovery

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[1] In the Tax Court, only one Judge filed a concurring opinion and seven Judges dissented.

of the previous tax benefit. There the Commisioner argued that upon the transfer of accounts receivable to a corporation as a part of a 26 U.S.C. § 351 incorporation, the unused portion of a bad debt reserve was includable in the taxpayer's income under the tax benefit rule because the "need" for the reserve had ended. The Court rejected this contention on the ground that the termination of the need for the reserve was not the equivalent of a recovery of the deductions which gave rise to the reserve for the purposes of the tax benefit rule. The Court implied, however, that had there been an actual economic recovery by the taxpayer, that is, by the receipt of securities for the accounts receivable, the value of which exceeded the receivables' net worth (the difference in the face value of the receivables less the bad debt reserve), the tax benefit rule would have been applicable.

I can see no difference between the "end of the need" argument set forth by the Government in *Nash* and the "inconsistent event" rationale used by the majority in this case. Certainly, were it not for *Nash*, Service's liquidation could have been characterized as the end of the need for the expense deduction relating to the tires and tubes, just as easily as the transfer in *Nash* of the accounts receivable to the corporation (prior to the time when the bad debts were actually realized) could have been characterized as an event inconsistent with the previous deduction of the bad debts. I cannot believe that this difference in semantics has a meaningful distinction for purposes of the tax laws.

Although the majority cogently points out the factual distinctions between the instant case and *Nash*, its attempt to distinguish the two on that factual basis fails because it does not take into account the pivotal factor in the Supreme Court's determination of *Nash*, namely, the failure of the taxpayer actually to recover economically the bad debt deduction. In the present case, as will be

shown below, it was Service's shareholders (not Service) who in reality recovered the tax benefit resulting from Service's expensing the tires and tubes at the time of their acquisition. Service, like the taxpayer in *Nash*, had no economic recovery of its prior tax benefit; rather, like the Section 351 incorporation in *Nash*, the liquidation merely ended Service's need for the deduction. This is not in my opinion, sufficient reason for an application of the tax benefit rule.

Adopting the reasoning of the majority of the Tax Court, the majority alternatively holds that even if an actual economic recovery is needed for the application of the tax benefit rule, such a recovery has occurred in this case. The recovery consists of a fictional receipt by Service immediately prior to its liquidation, of tires and tubes equal in value to the tires and tubes it distributed upon liquidation.[2]

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[2] The Tax Court majority created this fiction by the following reasoning:

> Service was permitted to expense the cost of the tires and tubes which it purchased, on the assumption that their useful life would be fully exhausted in its operations. Once Service had expensed their cost, the tires and tubes were therefore deemed to have been fully consumed in its operations for purposes of Federal income taxation whatever their fair market value may have been. If, having expensed the cost of the tires and tubes Service subsequently treated them as property having a fair market value in a transaction of consequence in the scheme of Federal income taxation, it would therefore necessarily be deemed to have received tires and tubes identical to them immediately prior to that transaction. Anders v. United States, 462 F.2d 1147, 1149 [30 AFTR 2d 72-5138] (Ct.Cl. 1972), cert. denied 409 U.S. 1064 (1972); Spitalny v. United States, 430 F.2d 195, 197-198 [26 AFTR 2d 70-5351] (9th Cir. 1970).
>
> When Service was liquidated, among the property which it distributed to petitioner, its sole shareholder, were tires and tubes having a fair market value of $36,394.67. Service had previously expensed the cost of these items. It must therefore be deemed to have received immediately prior to its liquidation, tires and tubes equal in value to those which it distributed.

This fictional receipt of tires and tubes by Service when it was already in possession thereof, is regarded by the majority as an event of independent significance which, consequently, is not subject to the non-recognition provisions of 26 U.S.C. § 336,[3] but which rather constitutes a recovery within the meaning of the tax benefit rule.

Despite the fictional receipt of tires and tubes, it is undeniable that in actuality, Service received no economic benefit upon liquidation.

In a liquidation under 26 U.S.C. §§ 332 and 334(b)(2) the value of the liquidating corporation's previously expensed assets is reflected in the amount paid to its shareholders for their stock. The liquidating corporation itself, however, receives nothing upon the sale of its stock by its shareholders. When the liquidating corporation distributes its previously expensed assets in kind upon liquidation, again it receives nothing for its assets except its own stock, which stock has no value upon the termination of the corporation's business and distribution of assets.[4] Thus the liquidating corporation receives no economic benefit upon liquidation, even though it was able to transmit to its shareholders the economic benefit from

[3] Section 336 provides:

> Except as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.

[4] The majority also holds that if an economic recovery is required for an application of the tax benefit rule, such a recovery is evinced by Service's receipt of its own stock in the liquidation. I fail to comprehend how this can constitute a recovery of a previous tax benefit. Certainly, it cannot be denied that the stock has *no* value upon the liquidation of the corporation. Where then is the requisite economic recovery necessary for an application of the tax benefit rule? Moreover, to attribute an economic recovery to the liquidating corporation from the transfer of its assets for its stock would circumvent the explicit nonrecognition language of 26 U.S.C. § 336.

previously expensing its assets. Because a liquidating corporation receives no economic benefit upon a liquidation in kind, I would hold that the tax benefit rule is inapplicable to such liquidations.

Furthermore, it is undisputed that Service had properly expensed the tires and tubes upon their acquisition. It owed no tax to the Government as a result thereof. Upon its liquidation under Section 336, Service's shareholder (*i.e.*, taxpayer) was entitled to receive the tires and tubes in the same condition as when possessed by Service and without any lien imposed thereon for taxes based upon an unfounded theory of a fictional receipt by Service of tires and tubes equal in value to those distributed by it upon liquidation.

In the only appellate case directly in point, namely, *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963), a panel majority of the Ninth Circuit refused to apply the tax benefit rule to a liquidation in kind because the liquidating corporation received no economic benefit upon liquidation. In that case South Lake Farms, Inc. was engaged in farming. In September 1956 an unrelated party, South Lake Farms, after arm's length negotiations with the shareholders of South Lake Farms, Inc., purchased all the stock of the corporation with the intent of liquidating it. The purchase price of the stock reflected the value of certain expenses incurred by South Lake Farms, Inc. in raising a cotton crop scheduled to be harvested in October 1956, and in preparing certain lands for the 1957 barley crop. South Lake Farms, Inc. was liquidated and its assets distributed in kind before it could reap what it had sown. On its final tax return South Lake Farms, Inc. deducted the expenses incurred in preparing the land for the barley crop and in raising the cotton crop. No income was reported, however, because unharvested crops could not be inventoried and the cotton crop was harvested after liquidation. As

a result of these events South Lake Farms, Inc. was able to claim a current operating loss and a carryback loss for the two prior years.

The Commissioner assessed a deficiency against South Lake Farms, Inc. Throughout the course of the litigation he asserted several theories under which the value of both the unharvested cotton crop and the cost of preparing the land for the barley crop should be recognized as income to the liquidating corporation. On appeal from an adverse decision of the Tax Court, the Commissioner raised for the first time the question of applicability of tax benefit principles.

In rejecting the Commissioner's contention, the majority of the court stated:

> Essentially, the Commissioner's position is that the old corporation got a "tax benefit" by deducting these expenses, all of which had been incurred or paid before liquidation. Such deduction was proper when taken. The contention is that because the price of the stock of the old corporation, which was sold to the new corporation, was fixed in part on the basis of the value of the cotton crop, and of the preparation of the land for a barley crop, and because an actual allocation of a portion of that price was made to those items, for the purpose of fixing the new corporation's basis under section 334, the old corporation received an amount equivalent to, and sufficient to offset, the expenses that it had incurred, and hence was no longer entitled to the "tax benefit" of the deduction of those expenses.
>
> One immediate difficulty with this contention is that the old corporation received nothing. It was the stock of the old corporation that was sold, and the stockholders who got the money. The price that they got was higher because of the values added to the

> old corporation's assets by the expenditures that were made in preparing the barley lands and in preparing, planting, and growing the cotton crop. No doubt they paid tax on the increased gain. Nowhere in the Code do we find an intent that gains of the stockholders were to be attributed to the corporation, much less that they were to be treated as ordinary income to the corporation. The corporation is to be taxed only on its own income. (Cf. Family Record Plan, Inc. v. Commissioner, supra, at 210 of 309 F.2d) [*Id.* at 839]
>
> . . . .
>
> The result in this case is something of a tax windfall to the stockholders of the old corporation. They got a price for their stock that was enhanced by their corporation's expenditures, which were deducted from its income, thereby reducing its income taxes, even though it never got the income that the expenditures were expected to produce. It may be that if Congress had considered the problem now before us when it enacted sections 334, 336, and 337 of the Internal Revenue Code, it would have inserted language designed to reach . . . the results here sought by the Commissioner. But it did not do so. [*Id.* at 840]

The majority rejects the decision of the Ninth Circuit in *South Lake Farms, Inc.*, and refuses to follow it. This results in a conflict in the Circuits' decisions.

I agree with the Ninth Circuit's decision. Service had no actual recovery consequent to its liquidation. It had previously paid for the tires and tubes and, undeniably, it had properly expensed them at the time of their acquisition or use. Upon liquidation Service received nothing of economic value to set off against the tax benefit obtained by deducting the cost of the tires and tubes

Again, neither the majority of the panel, the Tax Court majority nor the Commissioner has cited a single case in which the tax benefit rule has ever been applied solely on the basis of a fictional recovery of past deductions. To the contrary in every case cited by them, it was an actual economic recovery which triggered the application of the tax benefit rule. *See* cases cited *supra*. Underlying the fictional recovery applied both by the majority of this panel and by the majority of the Tax Court, there is a reliance on two cases which have held the tax benefit rule applicable to liquidations under 26 U.S.C. § 337,[5] namely, *Anders* v. *United States*, *supra*, and *Spitalny* v. *United States*, *supra*.[6] In each of these cases the Courts, as does the majority and the Tax Court majority, reconverted into property previously expensed assets. The fictional reconversion in *Anders* and *Spitalny*, however, did not constitute the requisite recovery for tax benefit purposes, but rather, was used to circumvent the nonrecognition provision of Section 337 so that the tax benefit rule could be applied. In a Section 337 liquidation, in contrast to a liquidation involving Section 336, the liquidating corporation clearly recovers the tax benefit obtained by expensing assets at the time of their acquisition through the sale of the previously expensed assets. This sale increases the liquidating corporation's net worth.

In applying the tax benefit rule to liquidations in kind, the Tax Court majority is obviously concerned with creating a parity in the tax treatment between liquidations

[5] Section 337 provides in pertinent part:

> (a) General Rule. If, within the 12-month period beginning on the date on which a corporation adopts a plan of complete liquidation, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

[6] The panel majority relies on only *Spitalny* v. *United States*, *supra*, while the Tax Court majority relies on both cases.

under Section 337 and those liquidations involving Section 336. *Compare Midland-Ross Corp.* v. *United States*, 485 F.2d 110 (6th Cir. 1974); *John T. Stewart, III Trust*, 63 T.C. 682 (1975).

In enacting Section 337, Congress did not evince an intent that all liquidations which utilize Section 336 have the identical tax result at the corporate level as a Section 337 liquidation. To the contrary, Congress was concerned with eliminating only the differences between *Court Holding Company* liquidations (324 U.S. 331 (1945)) and *Cumberland Public Service Company* liquidations (338 U.S. 451 (1950)), so that the tax consequences at the corporate level would be the same whether the liquidating corporation sold its assets and then distributed the proceeds to its shareholders in complete liquidation, or distributed its assets in kind to its shareholders for sale by them. *Central Tablet Mfg. Co.* v. *United States*, 417 U.S. 673, 678-82 (1974); *Midland-Ross Corp.* v. *United States*, *supra*, at 114-15, and authorities cited therein.

In attempting to create absolute parity in taxation results between all liquidating transactions which utilize Section 336 and those liquidations which utilize Section 337, the majority and the Tax Court majority have gone beyond the purpose underlying the enactment of Section 337. Moreover, in justifying the application of the tax benefit rule to the facts of this case by relying on Section 337 cases, they fail to perceive that Section 337 was enacted as a shield to protect the taxpayer, and not as a sword to be utilized by the Government.[7]

[7] One additional factor militates against the application of the tax benefit rule to the facts of this case. That factor is a double taxation (once at the shareholder level and again at the corporate level), of the economic value of the previously expensed but unused tires and tubes. It can be assumed that in purchasing Service's stock, the taxpayer paid Service's shareholders a price which included the value of the tires and tubes in its inventory. *Commissioner* v. *South Lake Farms, Inc.*, *supra* at 839. Thus Service was able to transmit to its

If there is to be parity in tax treatment under the two sections, the tax results dictated by Section 336 should control Section 337, and not vice versa. See *Midland-Ross Corp.* v. *United States, supra,* at 118.

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shareholders the benefit of the economic value of the previously expensed assets. The shareholders of Service undoubtedly paid a greater tax on the gain resulting from the sale of their shares of stock in Service because of the higher price paid to them for their stock, which higher price resulted from Service's possession of the tires and tubes. *Id.* at 839. The majority's application of the tax bentfit rule to the liquidation in kind results in income to Service by reason of its recovery of its previous deduction of the tires and tubes. This income is taxed to Service, resulting in a second tax on the economic value of the tires and tubes, at the corporate level.

Had Service been liquidated pursuant to Section 337, the economic value of tires and tubes would have been taxed only once, that is, as a result of Service's actual recovery of the previous deduction of their cost.

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No. 78-818

In the Supreme Court of the United States

OCTOBER TERM, 1978

TENNESSEE-CAROLINA TRANSPORTATION, INC.,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
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Washington, D.C. 20530

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The question presented in this federal income tax case is whether the courts below correctly held that the tax benefit rule requires a corporation to include in its income at the time of liquidation the fair market value of assets it distributes to its parent corporation when it had previously claimed a business expense deduction for the cost of those assets.

The facts are undisputed and may be summarized as follows: During 1966, Service Lines, Inc., a corporation then engaged in the motor freight transportation business, purchased truck tires and tubes, at a cost of $53,000. Because the tires and tubes had a useful life of no more than one year, Service deducted the $53,000 purchase price as a business expense on its 1966 tax return. In 1967, petitioner purchased 100% of Service's stock and thereafter liquidated Service and took direct possession of

Service's assets. Pursuant to Section 334(b)(2) of the Internal Revenue Code of 1954, petitioner claimed a stepped-up basis in the previously-expensed tires and tubes to reflect their value ($36,000) as of the date of liquidation. Petitioner thereafter claimed a $36,000 deduction with respect to those tires and tubes (Pet. App. A-2 to A-5; Pet. App. B-2).

On audit, the Commissioner of Internal Revenue determined that Service was required to include in its income at the time of the liquidation the fair market value of the tires and tubes it distributed to petitioner. In a reviewed opinion with seven judges dissenting, the Tax Court upheld the Commissioner's determination (Pet. App. A-1 to A-13).

The court of appeals affirmed (Pet. App. B-1 to B-9), with one judge dissenting (Pet. App. B-10 to B-20). It held that the tax benefit rule required Service to include the previously-expensed tires and tubes in income because there was an inconsistency between Service's expense deductions and petitioner's (Service's successor) claim to a tax basis in that same property. In so ruling, the court cited petitioner's concession that if Service had liquidated under Section 337, the tax benefit rule would have required that Service report as ordinary income the fair market value of the tires and tubes that it previously claimed as a business expense. In the court's view, "[t]here is no reason in either the statute or tax policy for reaching a different result in this case merely because Service and [petitioner] chose a §336 liquidation" (Pet. App. B-5).

1. One of the fundamental principles upon which the federal income tax is based is that income and expenses are computed in accordance with a system of annual accounting. *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931). Under this system, items of income and expenses properly accruable and attributable to a particular taxable year must be reported on the return for the year even

though circumstances may subsequently prevent the receipt of such income or the payment of such expenses. For those events, the annual accounting system requires that any adjustments made as a result of changed circumstances occurring in a subsequent year must be reported on the return for the subsequent year and not for the year in which the items were originally reported. See *Healy* v. *Commissioner*, 345 U.S. 278 (1953).

The "tax benefit" rule is a judicial doctrine that is a corollary of the annual accounting system. Under this rule, amounts deducted from gross income in one taxable year but "recovered" in a subsequent year must be included in income in the year of recovery. Thus, for example, if a taxpayer deducts state income taxes under Section 164 of the Code and those taxes are refunded to him in a subsequent year, he must include the tax refund in his federal taxable income. As the Court of Claims observed in *Alice Phelan Sullivan Corp.* v. *United States*, 381 F. 2d 399, 401 (1967): "[T]he principle is well engrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery." See, *e.g.*, *Dobson* v. *Commissioner*, 321 U.S. 231 (1944); *Burnet* v. *Sanford & Brooks Co.*, *supra*; *Home Savings and Loan Ass'n* v. *United States*, 514 F. 2d 1199 (9th Cir.), cert. denied, 423 U.S. 1015 (1975). Cf. Internal Revenue Code of 1954, Section 111; *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969).

The decision below correctly held that the tax benefit rule required Service to include the liquidation value of the tires and tubes in its income. Here, Service purchased $53,000 worth of tires and tubes during 1966 and claimed a business expense deduction for that year equal to their full cost on the assumption that they would be consumed in one taxable year. Rev. Rul. 59-249, 1959-2 Cum. Bull. 55. But subsequent events undermined the basis for that

assumption. As of its liquidation into petitioner, Service had not completely consumed the tires and tubes in its business. To the contrary, those items were still worth $36,000 when Service distributed them in 1966 to petitioner as a liquidating distribution. The fact that petitioner claimed a tax basis in the equipment equal to its fair market value as of Service's liquidation shows that they had value in that amount so as to cast doubt upon Service's previously claimed deduction. Under these circumstances, the tax benefit rule requires the inclusion in Service's income of the value of the tires and tubes. As the court of appeals observed (Pet. App. B-7), "[t]his transfer belied the assumption that they would be wholly consumed by Service. Thus, in order for Service to be able to transfer them to taxpayer they must be deemed to have been recovered by Service at that time."

2. Contrary to petitioner's contention (Pet. 8), the decision below does not conflict with Section 336 of the Code. That provision states that "no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation." But as the court of appeals correctly pointed out (Pet. App. B-4 to B-5), it is well settled that the similar nonrecognition rule of Section 337 applicable to liquidating corporations does not bar the application of judicial doctrines such as assignment of income or the tax benefit rule. Thus, for example, if Service had liquidated under Section 337 and sold its tires and tubes for $36,000, the tax benefit rule would have required it to include that $36,000 in income notwithstanding the terms of Section 337, which permit the nonrecognition of gain from the sale of property by a liquidating corporation. See, *e.g.*, *Commissioner* v. *Anders*, 414 F. 2d 1283 (10th Cir.), cert. denied, 396 U.S. 958 (1969); *Spitalny* v. *United States*, 430 F. 2d 195 (9th Cir. 1970). Similarly, the assignment of income doctrine has been held to require a corporation to recognize income with respect to a liquidating distribution of work

in process despite the nonrecognition rule of Section 337. *Storz* v. *Commissioner*, 583 F. 2d 972 (8th Cir. 1978); *Midland-Ross Corp.* v. *United States*, 485 F. 2d 110 (6th Cir. 1973). As the court of appeals correctly concluded, "[t]here is no reason in either the statute or tax policy for reaching a different result in this case merely because Service and [petitioner] chose a §336 liquidation" (Pet. App. B-5).

Nash v. *United States*, 398 U.S. 1 (1970), upon which petitioner relies (Pet. 5-6), is distinguishable. There, this Court held that the tax benefit rule did not require the members of a partnership to include in income the amount of bad debt reserves attributable to the partnership's accounts receivable upon the partnership's Section 351 transfer of its assets to a corporation in exchange for stock. In so holding, the Court rejected the Commissioner's argument that the winding up of the partnership's business terminated its need for the bad debt reserve and that termination was a recovery of an item that produced an income tax benefit within the ambit of the tax benefit rule. As the Court viewed the matter, since the value of the stock was equal to the net value of the receivables (face amount less the reserve), there was no recovery of any item.

Here, however, Service transferred equipment to petitioner that Service had entirely written off but which had an undisputed value of $36,000, as demonstrated by petitioner's claim of basis in that amount. As the court of appeals correctly observed (Pet. App. B-8), "Thus, unlike the instant case, in *Nash* the taxpayers did *not* transfer an item (or any portion thereof) which had been the subject of a prior deduction, but rather transferred only what was left after the deduction. Here, Service clearly transferred items which had been the subject of prior deductions" (emphasis in original). See Rev. Ruls. 78-278, 78-279, 1978-30 Int. Rev. Bull. 5, 6 (July 24, 1978).

3. Finally, petitioner argues (Pet. 4-5, 7) that the decision below conflicts with *Commissioner* v. *South Lake Farms, Inc.*, 324 F. 2d 837 (9th Cir. 1963). There, a corporation liquidated and transferred its assets (unharvested crops with respect to which it had claimed growing expenses) to a second corporation which owned all of its stock. The Commissioner sought to include in the income of the liquidating corporation the liquidation date value of its unharvested crops under Section 446(b) or alternatively deny it a deduction for the crop growing expenses under Section 482. The Tax Court rejected both contentions (36 T.C. 1027 (1961)). In the court of appeals, the Commissioner abandoned his Section 482 argument and relied solely upon Section 446(b), which provides that "if the method [of accounting] used [by a taxpayer] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income."

A divided court of appeals affirmed. It ruled that no method of accounting would have required the liquidating corporation to include the value of its unharvested crops in income. It further held that Section 446(b) could not be used to disallow the crop growing expenses to the liquidating corporation. As the court stated, "[t]o use section 446(b) in this case as proposed would, we think, circumvent the provisions and purposes of sections 334 and 336 of the Code" (324 F. 2d at 839). In so holding, the court rejected the Commissioner's argument that the liquidating corporation received a tax benefit from the crop growing expenses and recovered that item through an enhanced price upon the sale of its stock.

To be sure, the Ninth Circuit's observations in *South Lake Farms* with respect to Section 336 are not entirely consistent with the analysis of the court below. Thus, the court of appeals in this case rejected the authority in *South Lake Farms* (Pet. App. B-6 n.13) and the

dissenting judge heavily relied upon it (Pet. App. B-15 to B-17). But the decision in *South Lake Farms* can be read as principally turning upon the Ninth Circuit's view that the Commissioner's authority under Section 446(b) to prescribe methods of accounting did not extend to the disallowance of the liquidating corporation's crop growing expenses. In this sense, the court's statements with respect to Section 336 and the tax benefit rules were dicta that were not essential to its holding with respect to Section 446(b). Indeed, since its decision in that case, the Ninth Circuit has cast doubt upon its dicta in *South Lake Farms* by holding in two cases that neither Section 336 nor 337 bar application of the tax benefit rule to liquidating corporations. *Spitalny* v. *United States*, 430 F. 2d 195 (9th Cir. 1970) (tax benefit rule requires inclusion in income of previously-expensed cattle feed by corporation liquidating under Section 337); *Home Savings and Loan Ass'n* v. *United States*, 514 F. 2d 1199 (9th Cir.), cert. denied, 423 U.S. 1015 (1975) (tax benefit rule requires inclusion in income of bad debt reserve by savings and loan association liquidating under Section 336). These subsequent decisions, which are in accord with the rationale of the court below, suggest that the dicta in *South Lake Farms* may no longer represent the authoritative view of the Ninth Circuit with respect to the question presented in this case.[1]

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[1] In *Home Savings and Loan*, the court stated that it did not intend to impair the authority of *South Lake Farms* (514 F. 2d at 1201 n.1). But the court made that statement in the course of observing that the taxpayer in that case was not asserting that *South Lake Farms* stood for the proposition that the accrual of earned but not reserved income was improper. Thus, to the extent that the court intended to preserve the authority of *South Lake Farms*, it was with respect to its holding dealing with Section 446(b) and not the dicta addressing Section 336 and the tax benefit rule.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-818

TENNESSEE-CAROLINA TRANSPORTATION, INC.
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE
RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITIONER'S REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

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Pursuant to Rule 24(4) of the *Rules of the Supreme Court of the United States*, the Petitioner makes this reply to the Respondent's Memorandum in Opposition to Tennessee-Carolina Transportation, Inc's Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

In his Memorandum in Opposition to the Petition for a Writ of Certiorari, the Commissioner argues that the lower Court's decision has correctly interpreted the tax benefit rule. Secondly, he argues that the decisions

below do not conflict with Section 336 of the Internal Revenue Code. Finally, the Respondent argues that the decision below is not in conflict with *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837 (C.A.9, 1963). These contentions will be answered seriatim.

The Respondent on pages two through four of his memorandum argues for the continuing validity of the tax benefit rule. The Petitioner is not contesting the validity of the tax benefit rule. It is only contesting its interpretation and application by the Tax Court and the Court of Appeals for the Sixth Circuit in a new and novel way. On page three of his Memorandum in Opposition, Respondent sets out the following principle:

> The principle is well ingrained in our tax law that the *return or recovery* of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery. [Emphasis Added]

The Respondent's argument glosses over the lower Courts' new and novel application that ignores the lack of an actual return or recovery of property by Service Lines, Inc., the liquidating corporation. The recovery, if any, was by the old shareholders of Service. Thus ignoring the absence of a recovery, the Respondent merely argues the validity of the tax benefit rule. His argument neglects the fact that the lower Courts have applied this important judicial doctrine in a manner that conflicts with all previous Court decisions applying the tax benefit rule.

Secondly, the Respondent asserts that the decisions below do not conflict with Section 336 of the Internal Revenue Code. The plain language of that Section clearly provides that "no gain or loss should be recognized to a corporation on distribution of property in partial or complete liquidation." Yet, that has happened in this case. The Respondent justifies his position by equating a liquidation under Section 337 of the Internal Revenue Code to the present liquidation under Section 336 of the Internal Revenue Code. What the Respondent fails to recognize in his argument is the existence of an actual recovery by the corporation liquidating under Section 337. In a Section 336 liquidation, the recovery, if any, is by the shareholders not the corporate taxpayer.

Finally, the Respondent argues that the decisions do not conflict with *Commissioner* v. *South Lake Farms, Inc., supra.* In his Memorandum in Opposition, the Respondent implies that only the dissenting circuit judge recognizes *South Lake Farms, Inc.* to be *contra* to the majority holding in this case. This implication by the Respondent ignores the majority's holding that there need not be an actual physical "recovery" of a tangible asset or sum in order to apply the tax benefit rule. Even the majority of the Court of Appeals realized this holding was in conflict with *South Lake Farms, Inc.* (See footnote 13 of the majority opinion wherein they state that "We reject the contrary holding in *Commissioner* v. *South Lake Farms, Inc. . . .*" (Pet., App. B-6)).

In his attempt to distinguish the conflict between *South Lake Farms, Inc.* and the present case, the Respondent relies on *Spitalny* v. *United States*, 430 F.2d 195 (C.A.9, 1970) and *Home Savings and Loan Association* v. *United States*, 514 F.2d 1199 (C.A.9, 1975), cert. denied 423 U.S. 1015 (1975). His purpose is to contest the continuing validity of *South Lake Farms, Inc.* as the law in the Ninth Circuit. However, those cases do not resolve the conflict since *Spitalny* involved a Section 337 liquidation rather than the present Section 336 liquidation. Moreover, *Home Savings and Loan Association* does not stand for the

proposition that the tax benefit rule requires the inclusion in income of a bad debt reserve by a savings and loan association liquidating under Section 336. The ultimate issue in *Home Savings and Loan Association* was whether or not the corporations had undergone a statutory reorganization pursuant to Section 368(a)(1)(A) or had undergone a liquidation with the basis of the assets being determined under Section 334(b)(2). The significance of the ultimate issue is that Section 593 requires the previously deducted bad debt reserve to be included in income only upon liquidation. Since there was a liquidation, Section 593 and not the tax benefit rule required that the nonrecognition provisions of Section 336 be overridden. This situation is similar to the holdings that the recapture provisions of Section 1245 will override the nonrecognition provisions of Section 336. Consequently, the decision of the Ninth Circuit in *South Lake Farms, Inc.* is still the law in that Circuit and is in direct conflict with the decision of the Sixth Circuit in the present case.

Respectfully submitted,

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